ORIGINAL

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992 -- Rate Regulation;	)	MM Docket No. 93-215
	)	
Adoption of a Uniform Accounting System for Provision of Regulated Cable Service	)	CS Docket No. 94-28

COMMENTS OF CONTINENTAL CABLEVISION, INC., CROWN MEDIA, INC., JONES INTERCABLE, INC., KBLCOM, INC., SCRIPPS HOWARD CABLE CO., TELECABLE CORPORATION, GREATER MEDIA, INC., RIFKIN & ASSOCIATES, INC., TCA CABLE, INC., WESTERN COMMUNICATIONS, ALLEN'S TV CABLE SERVICE, INC., AMERICAN CABLE ENTERTAINMENT, BENCHMARK COMMUNICATIONS, BROWNWOOD TELEVISION CABLE SERVICES, INC., CABLEAMERICA CORP., CABLESOUTH, COLUMBUS TELEVISION CABLE CORP., DANIELS CABLEVISION, INC., GILMER CABLE TELEVISION CO., HALCYON COMMUNICATIONS, INC., JAMES CABLE PARTNERS, OCB CABLEVISION, INC., SJOBERG'S INC., STARSTREAM COMMUNICATIONS, UNITED VIDEO CABLEVISION, ZYLSTRA COMMUNICATIONS CORP., CABLE TELEVISION ASSOCIATION OF GEORGIA, CABLE TELEVISION ASSOCIATION OF MARYLAND, DELAWARE AND THE DISTRICT OF COLUMBIA, NEW JERSEY CABLE TELEVISION ASSOCIATION, SOUTH CAROLINA CABLE TELEVISION ASSOCIATION, TENNESSEE CABLE TELEVISION ASSOCIATION, AND TEXAS CABLE TV ASSOCIATION REGARDING THE INTERIM COST-OF-SERVICE RULES AND THE FURTHER NOTICE OF PROPOSED RULEMAKING

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July 1, 1994

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EXECUTIVE SUMMARY

The undersigned cable operators and associations[1] commend the Commission for the substantial progress it has made in trying to adapt cost-of-service regulation to the unique legal, technological, and financial circumstances of the cable television industry.

Several factors make this task particularly challenging. Until the passage of the 1992 Cable Act, the cable industry was unregulated, so the Commission has had little experience with the financial and operational aspects of the cable industry, and the industry with rate regulation. The industry has only recently completed the massive capital investment needed to build out the cable infrastructure to pass more than 90% of homes. Moreover, in many cases, this major capital program and related efforts to begin a logical consolidation of a geographically fragmented industry have been funded by debt. Finally, rapid advances in cable technology are creating the need for even more investment by the industry.

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[1] The participating cable operators include: Continental Cablevision, Inc., Crown Media, Inc., Jones Intercable, Inc., KBLCOM, Inc., Scripps Howard Cable Co., TeleCable Corporation, Greater Media, Inc., Rifkin & Associates, Inc., TCA Cable, Inc., Western Communications, Allen's TV Cable Service, Inc., American Cable Entertainment, Benchmark Communications, Brownwood Television Cable Services, Inc., CableAmerica Corp., CableSouth, Columbus Television Cable Corp., Daniels Cablevision, Inc., Gilmer Cable Television Co., Halcyon Communications, Inc., James Cable Partners, OCB Cablevision, Inc., Sjoberg's Inc., Starstream Communications, United Video Cablevision, Zylstra Communications Corp. The participating state associations include: Cable Television Association of Georgia, Cable Television Association of Maryland, Delaware and the District of Columbia, New Jersey Cable Television Association, South Carolina Cable Television Association, Tennessee Cable Television Association, Texas Cable TV Association.

To further complicate matters, the 1992 Cable Act directs the Commission to consider a number of factors, including the need to encourage the development of the industry and the deployment of new technology. These equally important statutory goals are often at odds with the already complex task of determining rates that are reasonable under traditional regulatory principles.

In these circumstances, it should not be surprising to either the Commission or the industry that the first attempt to develop specific rules for applying cost-of-service regulation to cable television would need further consideration and refinement. And, in fact, as described below, the Commission's interim cost-of-service rules should be revised in several respects in order fairly and effectively to implement the purposes of the 1992 Cable Act.

First and foremost, the Commission should revise the interim rules' approach to the treatment of intangible assets in cable operators' rate bases. Many cable operators have endured massive losses and extended periods of low earnings in developing and expanding their systems. Both long-standing precedent and very recent federal court decisions indicate that a substantial allowance for these losses and low earnings should be included in cable operators' rate bases. The interim rules, however, impose limits on the amount of any such allowance that are unrealistic in light of the actual capital invested in developing cable systems. The rules should be revised to provide a realistic allowance for early period losses and low earnings that characterize this industry.

For exactly the same reasons, the Commission should also revise the treatment of intangible assets recorded on operator's books in connection with the acquisition of another cable system. The prices paid for cable systems appropriately reflect the real investments made in those systems, including investments represented by the prior owners' continuing efforts to develop and expand those systems over the long term, despite recurring losses and low earnings. As an accounting matter, the portion of the purchase price relating to these investments is recorded as an "intangible asset." But these investments in system development and expansion are real and tangible in the most basic sense: if the prior owners had not been willing to endure long periods of losses and low earnings, the cable systems serving customers today simply would never have been built.

As with losses and low earnings incurred by a system that has never been sold, the interim cost-of-service rules impose severe limits on the amount of intangible assets recorded on operators' books in connection with the purchase of other systems. To avoid penalizing operators who paid reasonable prices for the systems they acquired, in light of both the tangible and intangible investments in those systems by prior owners, the Commission should revisit this issue.

In general, there is no reason to disallow any acquisition-related intangibles at all. But there are a number of equitable, middle-ground approaches to this problem that are more fair and balanced than the approach embodied in the interim rules. Where records are available, the current system owner may be able to calculate the losses and forgone earnings which the prior owners endured and which are included in the current owner's purchase

price. Or, the Commission could develop or accept evidence relating to an "average schedule" of per-subscriber losses and low earnings that could reasonably be included as intangible assets in the ratebases of acquired systems. As another alternative, the Commission's revised benchmark analysis provides the basis for a presumption regarding intangibles. This revised presumption, while still quite harsh, eliminates any prospect that acquisition-related intangibles contain the slightest residuum of capitalized "monopoly profits" without disallowing 100% of those intangible assets, which is the practical effect of the interim rules.

More important than the specific alternative adopted to allow a reasonable amount of acquisition-related intangibles into the rate base is the recognition that the true measure of the capital the current owner has devoted to the provision of cable service is the actual purchase price paid. Equally important is a recognition that most of the acquisitions at issue took place during a period when Congress had determined that the public interest was best served by a generally deregulated cable industry. If, at the end of the day, the Commission cannot see its way clear to allowing all of a current owner's actual investment into the rate base, then at the very least, the rules should specify that any amounts excluded will be amortized over a reasonable period. Any other approach would utterly and retroactively destroy the value of millions of dollars of investment that was prudent and reasonable when made.

There are other important ways that the interim rules should be clarified or changed to properly adapt the principles of cost-of-service regulation to the unique circumstances of the cable industry. These are summarized below.

The overall allowed return for regulated cable operations should be increased from 11.25% to at least 13%. Certain key characteristics of the cable industry — including, most prominently, the fact that cable companies generally do not pay dividends — indicate that cable companies will face a much higher cost of capital than the market as a whole, or than telephone companies, who also have an allowed 11.25% overall return. Unfortunately, the Commission's preferred method for estimating the cost of equity capital, the Discounted Cash Flow ("DCF") model, by its very nature cannot be applied to firms that do not pay dividends. An established alternative model, the Capital Asset Pricing Model ("CAPM"), can be applied to such firms, and the undersigned operators and associations engaged The Brattle Group to perform such an analysis.

Both the CAPM and the DCF lead to similar results for the dividend-paying firms to which they both apply. This shows that there is no systematic bias in either model. When the CAPM is applied to non-dividend paying firms (to which the DCF cannot be applied) the result is that, as one would expect, non-dividend paying firms are substantially riskier than the market as a whole. Similarly, applying the CAPM to a reasonable sample of cable television companies — which, in addition to paying no regular dividends, are subject to a number of other significant business risks — also shows a much higher cost of equity than the market as a whole. In this latter analysis, The Brattle Group has

specifically addressed the concerns the Commission expressed about applying the CAPM model to cable firms. On the basis of this analysis, the Commission should adopt an overall, after-tax allowed return for regulated cable services of 13%.

The interim rules represent a good first step towards meeting the objective of the 1992 Cable Act of encouraging the development and expansion of cable systems. Nonetheless, some important revisions are in order. First, the Commission should clarify that all operators are permitted to make "streamlined" cost-of-service showings to reflect major upgrade costs in rates, regardless of whether the initial permitted rate is established under the benchmark or cost-of-service principles. While we believe that this was the Commission's intent, some ambiguity on this issue remains, and should be eliminated. Second, the Commission should allow cable operators to justify and implement rate increases to cover the cost of a system upgrade according to a reasonable schedule provided by the operator, and not force a delay until the entire upgrade is completed. In general, the only realistic source of funds to cover the cost of an upgrade is increased revenues from customers, so this accommodation is necessary if the upgrade is to occur at all. Moreover, this approach modifies strict utility-style regulation in light of the specific directive of the Cable Act, that the Commission encourage economically justified expansion and development of cable systems.

The Commission should not prescribe a Uniform System of Accounts for cable operators at this time. The burdens of conforming the wide diversity of accounting systems used in the industry to a uniform system far outweigh the benefits, for two reasons. First,

the Form 1220 and Form 1225 will already provide the Commission with a standardized presentation of the financial data needed to implement cost-of-service regulation. Second, one of the key purposes of the 1992 Cable Act is to encourage competition in the cable industry, and once competition develops, rate regulation is no longer permitted. To the extent that the massive burdens of uniform accounting produce any benefits at all, therefore, those benefits would be short-lived.

The Commission should also reject the proposal to impose a 2% productivity offset on cable operators in connection with the cable industry's price cap plan. There is no credible evidence to suggest that a 2% offset is appropriate. Moreover, the goals of the 1992 Cable Act regarding rate regulation are fully met by a limitation of price increases to the overall level of inflation. Finally, the significant new service quality requirements imposed by the Act are themselves, in effect, a mandated improvement in the productivity of cable operators, so the additional 2% offset is unwarranted.

The Commission should also amend the interim rules to clarify certain aspects of allocating the costs of cable plant and related expenses among service tiers. We believe that the most reasonable cost allocation methodology is one which, like the Commission's rules regarding separation of telephone plant between the state and interstate jurisdictions, fairly reflects the usage of the plant. We request the Commission to adopt this view in its permanent rules. For ratemaking purposes, the Commission should also clarify the calculation of the allowance in rates for income taxes, in order that this calculation will be consistent with other aspects of the ratemaking equation.

Finally, in a number of areas, the Commission should clarify and revise the procedures and general approach to be applied in cable cost-of-service cases. The Commission should clarify that regulators may approve maximum reasonable rates below which a cable operator would be granted pricing flexibility without being subject to new rate review each time a price is changed. A cable operator whose rates have not increased more than inflation since the beginning of deregulation under the 1984 Cable Act should not be put to the burden of a full cost-of-service defense in the absence of some specific evidence — not merely a complaint — that its current rates are too high. Cable operators should be entitled to receive notice from regulators (or their staffs) of specific perceived defects in their cost-of-service filings and be given an opportunity to correct those defects. Cable operators should have reasonable rights of discovery regarding consultants' reports or other analyses upon which a regulator proposes to rely in setting the cable operator's rates. And, in general, regulators should target their regulatory efforts to establish the highest reasonable rate under traditional cost-of-service principles, both because this is the best way to balance the competing goals of the 1992 Cable Act, and because it represents the minimum accommodation necessary to reflect, in the cost-of-service context, the fact that the prices being regulated are prices for speech that is subject to the protections of the First Amendment.

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On March 30, 1994, the Commission adopted "interim" rules governing cost-of-service showings by cable operators, and sought comments on those interim rules.[1] These

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[1] In the Matter of Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, ***Report and Order and Further Notice of Proposed Rulemaking,*** MM Docket 93-215, FCC 94-39 (released March 30, 1994) (***"Cost of Service Order"***).

comments are being filed by the undersigned cable operators and associations,[2] many of whom either already have filed, or are considering filing, cost-of-service justifications for their rates in some jurisdictions. As described more fully below, the Commission should make a number of substantive and procedural revisions to the interim cost-of-service rules in order to create fair and workable permanent rules.

In addition, undersigned cable operators and associations respectfully respond to the following specific issues on which the Commission requested comments: (1) the adequacy of the interim 11.25% overall allowed return; (2) the proposed 2% productivity offset for use in the price cap plan; (3) the proposal to establish a uniform system of accounts for cable operators making cost-of-service showings; and (4) the streamlined cost-of-service option available to reflect system upgrades.

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[2] The participating cable operators include: Continental Cablevision, Inc., Crown Media, Inc., Jones Intercable, Inc., KBLCOM, Inc., Scripps Howard Cable Co., TeleCable Corporation, Greater Media, Inc., Rifkin & Associates, Inc., TCA Cable, Inc., Western Communications, Allen's TV Cable Service, Inc., American Cable Entertainment, Benchmark Communications, Brownwood Television Cable Services, Inc., CableAmerica Corp., CableSouth, Columbus Television Cable Corp., Daniels Cablevision, Inc., Gilmer Cable Television Co., Halcyon Communications, Inc., James Cable Partners, OCB Cablevision, Inc., Sjoberg's Inc., Starstream Communications, United Video Cablevision, Zylstra Communications Corp. The participating state associations include: Cable Television Association of Georgia, Cable Television Association of Maryland, Delaware and the District of Columbia, New Jersey Cable Television Association, South Carolina Cable Television Association, Tennessee Cable Television Association, Texas Cable TV Association.

I. THE COMMISSION SHOULD RECOGNIZE THE LEGITIMATE COSTS OF INTANGIBLE ASSETS IN THE RATE BASE.

The Cost-of-Service Order establishes a presumption against recognizing most intangible assets in a cable operator's rate base.[3] The stated basis for the presumption is the concern that intangible assets, especially intangible assets recorded in connection with the acquisition of a cable system, represent a capitalization of future monopoly profits.[4] As described below, this presumption should be rejected, or at least very substantially revised, in the permanent cost-of-service rules.

A. The Commission's Rules Should Recognize That Cable Operators Legitimately And Necessarily Incur Long Periods of Losses and Low Earnings In Developing A Cable Business.

A key difficulty in applying traditional cost-of-service principles to the cable industry arises from the fact that cable systems are generally long-lived assets that do not produce stable returns over the course of their useful life. Quite the contrary: a typical cable system operates at a loss or with extremely low book earnings for a number of years, then at high earnings levels for a number of years more.[5]

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[3] ***Cost of Service Order*** at ¶ 99.

[4] ***Cost-of-Service Order*** at ¶ 91. The Order also expresses some concern that, in addition to capitalized monopoly profits, acquisition prices might also reflect anticipated earnings from non-regulated activities. ***Id.*** at ¶ 92. This latter concern, however, does not warrant disregarding the intangible assets in their entirety. Instead, it simply means that care must be taken in allocating the "total company" asset base among regulated and unregulated activities.

[5] ***See*** Declaration of Colleen Millsap, attached hereto as Exhibit A ("Millsap Declaration"). Ms. Millsap is Chief Financial Officer of Benchmark Communications. Her declaration was previously submitted to the Commission in connection with pending petitions for reconsideration (continued...)

Investors in cable systems understand this economic reality and invest for the long term, expecting that the losses and low earnings in earlier years will be made up by higher earnings in later years. Over the long term, expected earnings are not out of line with other investments of comparable risk. Except during a few years in the middle of the system's life cycle, however, returns will be first below, and then above, a "reasonable" level.[6]

From an economic perspective, the situation is similar to the purchase of an investment that pays no interest on a current basis, such as a parent purchasing US savings bonds to finance a child's college education. The price paid for a long-term bond is a fraction of the bond's face value. The bond will only achieve its face value, however, after many years, as interest on the original investment has accumulated. The same is true for any investment which does not pay current returns. Zero-coupon bonds, for example, pay no interest until they mature, but the purchaser knows that the longer the bond is held, the more interest is earned. Like the savings bond, when the zero-coupon bond matures, the investor is paid back not only the original investment, but also for the use of money for all the years the bond was held.[7]

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[5](...continued)
of the interim cost-of-service rules. ***See*** Response Of Continental Cablevision Inc., Benchmark Communications, L.P., And Cablesouth, Inc., To Petitions For Reconsideration Of Comcast Cable Communications, Inc., Et Al., MM Docket No. 93-215 (filed June 16, 1994).

[6] ***See, e.g.,*** In the Matter of New England Cable News, ***Memorandum Opinion and Order***, Docket CSR-4190-P, FCC 94-133, ¶ 35 (released June 1, 1994). ***See also*** Exhibits B and C hereto, which contain financial information regarding the operations of two undersigned cable operators, KBLCOM, Inc., and Rifkin & Associates, respectively. These data were presented in a previous round of comments in this proceeding, and are included here for ease of reference. Comments of Cable Operators and Associations, MM Docket No. 93-215 (August 25, 1993).

[7] ***See*** Letter from P. Glist to P. Donovan, ***ex parte,*** MM Docket No. 93-215 (February 14, 1994).

Investments in cable television systems are analogous. Historically, as cable systems were built, penetration — subscribers as a percentage of homes passed — was in the 30% to 40% range. Through years of effort, subscribers are attracted to the system, penetration increases, and in time, often five years or more, the system begins to record positive, though still low, earnings. As in the case with the purchase of a savings bond or a zero-coupon bond, however, the investment has earned no return during those years. Instead, the investor has accumulated losses and forgone any return.[8]

Had cable operators been regulated while these losses and low earnings were inevitably incurred, the operator would likely have recorded them as a regulatory asset for later recognition. But for most of the cable industry, the period of sustained losses occurred during an era when rate-base, rate-of-return, common carrier-type regulation was not in effect. In these circumstances, there was no basis for creating a "regulatory asset." Instead, businesses were built and multi-million dollar investments made based on the expectation that, eventually, penetration would increase, assets would be depreciated and amortized, and long-awaited earnings would finally be realized. At this point, the firm's net worth would finally begin to grow.

The public interest was served by entrepreneurs who were willing to incur losses and forgo earnings for so many years. As recently as 1980, cable television was generally a niche service, offering improved television reception and offering a few cable-specific program offerings. Today, cable is available to almost everyone, and penetration — while

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[8] ***Id.***

still below the truly "universal" coverage of telephone and other utilities — has increased dramatically,[9] due largely to the tremendous number of programming choices now available. For the first time in the history of television, consumers are not dependent on the networks for broadly available, high-quality news, educational, and entertainment programming.

None of this would have been possible without the willingness of cable entrepreneurs to defer any return on their investment until many years after the investment was made. This investment cycle is quite unlike that of traditional utilities and warrants an equitable and reasonable regulatory response. Specifically, the losses and low earnings in the early years of a cable system's life should be treated as additional investments in the enterprise. These amounts should be added to the cable operator's rate base, so that future earnings will be fairly evaluated with the initial losses and low earnings taken into account.

In the ***Cost-of-Service Order***, the Commission accepted the key concept underlying this analysis:

> We conclude that some accumulated start-up losses, to the extent that they reflect operating losses in the early years of the system, should be included in the rate base. These losses could be considered to meet the used and useful standard in that it is frequently necessary for businesses during a start-up phase to sustain a period of losses prior to profitability. As such, the losses benefit customers because it is necessary for the operator to incur them in order to bring future services to subscribers.

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[9] In 1980, total cable subscribership was approximately 16,000,000; by 1992, that had grown to approximately 53,000,000. Warren Publishing, Inc., ***TV & Cable Fact Book,*** No. 60 at G-64 (1992). By 1992, cable systems passed more than 78,000,000 homes, out of approximately 92,000,000 TV households. ***Id.*** at G-20.

Cost-of-Service Order at ¶ 70 (footnote omitted). As described below, however, the Commission should revise its rules defining the amount of early losses and low earnings that may be included in the rate base.

The amount of additional investment that should be added to rate base can be calculated by reference to the system's historical financial records. All earnings shortfalls below a reasonable level, should be added to a rate base account established for this purpose.[10] Each subsequent year's earnings shortfall should be calculated and added to the accumulated shortfall, with cumulative prior year shortfalls included in the investment base each year.[11] Finally, when earnings reach the stage that they exceed a reasonable level on a current basis, the excess over the reasonable level should be credited against the "accumulated losses/low earnings" account on a going-forward basis.[12] Eventually, the system will be upgraded, requiring significant new capital, which will restart the investment cycle described above.

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[10] The FCC's interim 11.25% overall after-tax return can be used as a conservative estimate of a "reasonable" return level for these purposes until a permanent overall return is set. The 11.25% figure is conservative because in the not-too-distant past, interest rates were much higher than current levels, and equity was more expensive as well. As a result, the Commission's interim 11.25% figure — which understates ***current*** returns, as explained in Section V, ***infra*** — will understate the cost of capital in prior periods. ***See*** The Brattle Group, "Rate of Return Recommendations in Cable Television Cost-of-Service Regulation," attached hereto as Exhibit G ("Brattle Group Report").

[11] This will automatically reflect the fact that there is a cost of money associated with leaving the losses and low earnings unrecovered in the business for a number of years.

[12] An alternative approach would be to calculate each year's earnings on a pure "book" basis, without recognition of prior period shortfalls, but to add a cost-of-money allowance to the cumulative shortfall each year. When "book" earnings exceed a reasonable level, the accumulated shortfall would be amortized by the excess until the accumulated shortfall reaches zero.

The precedent in the field of cable rate regulation supports such an allowance. In 1977, during an earlier period of cable rate regulation, the Massachusetts Cable Television Commission held that:

> [O]perating losses are properly allowable in the rate base because they represent funds prudently invested in the construction and maintenance of the system at a time when the bulk of expenditures had to be made. ... A policy specifically prohibiting the opportunity to earn a return on these funds would jeopardize the economic viability of systems that have experienced substantial prior losses ... [and] might have a chilling effect on the development of cable in Massachusetts.

Stan-Fran Corp. in Haverhill and Groveland, Docket No. AFD-10, AFD 24 at 5 (Mass. Community Antenna Tel. Comm'n, Feb. 17, 1977).

More recently, a federal court in Illinois was confronted with the question of whether a cable operator's rates were "reasonable" under the rate regulation provisions of the 1984 Cable Act. The local franchising authority claimed that the cable system's high book earnings in recent years showed that current rates were too high. The court, however, disagreed, holding that:

> [The] earlier years [1982-84] will not be excluded when judging whether [the cable operator]'s rate of return in 1987-91 was reasonable. A cable system is a long-lived asset. Cable companies and investors analyze rates of return on such assets over their life-cycle. To do otherwise would disregard the reality that the costs of building or rebuilding a cable system are concentrated in the early years. The rate of return during these early years is typically low or even negative. Years after the investment, however, returns increase. ***The proper way to evaluate the reasonableness of rates is to incorporate into the analysis what happens in the earlier years.***

City of Ottawa, Illinois v. Sammons Communications, 836 F. Supp. 555, 561 (N.D. Ill. 1993) (emphasis added).[13]

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[13] Older precedent, not directly related to the cable industry, also supports including intangible assets in rate base. "The thing devoted by the [regulated company] investor to the (continued...)

The interim rules are inconsistent with this precedent in a key respect. Specifically, they generally limit the amount of initial losses and low earnings that may be included in the rate base to those amounts that a cable operator may have capitalized pursuant to the terms of Statement of Financial Accounting Standards No. 51 (SFAS-51).[14] Amounts capitalized under SFAS-51, however, will not accurately reflect the actual level of investment in the system, whether in terms of hard dollars spent or return forgone.[15]

SFAS-51 presumes that the correct period for assessing the entity's earnings is a single calendar year, and generally respects the rule that, once revenue is derived from a system, ongoing expenses should be treated as such, rather than capitalized. SFAS-51 then recognizes a limited exception to that rule where a cable system is largely still under

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[13](...continued)
public use is not specific property, tangible and intangible, but capital embarked in the enterprise. Upon ***the capital so invested***, the Federal Constitution guarantees to the [regulated company] an opportunity to earn a fair return." ***Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n,*** 262 U.S. 277, 290 (1922) (Brandeis, J., concurring) (emphasis added). In this regard, courts have noted that Justice Brandeis's "central idea that the investor's legally protected interest resides in the ***capital he invests*** in the [regulated firm] rather than the items of property which the capital purchases for provision of [regulated] service" has prevailed. ***Democratic Central Committee v. Washington Metro Area Transit Commission,***, 485 F.2d 786, 801 (D.C. Cir. 1973) (emphasis added). As noted above, in the case of cable systems with prolonged initial periods of losses and low earnings, the amount of capital actually invested in the system far exceeds the net book value of tangible assets recorded on the firm's books for accounting purposes. These precedents establish that it is the capital actually devoted to the cable system, and not merely the capital embodied in "hard" assets, that should be included in the rate base.

[14] ***Cost-of-Service Order*** at ¶¶ 70-73.

[15] ***See*** Exhibit D hereto, which is a letter from the accounting firm of Deloitte & Touche, explaining the history and function of SFAS-51.

construction, but some revenues are being received from some customers. In that case, certain costs will be capitalized rather than expensed.[16]

But these capitalized amounts have no bearing on whether investors in cable systems will obtain reasonable earnings from their investment over the life of the system. As stated by the accounting firm of Deloitte & Touche:

> SFAS 51 does not address the question of whether investors in cable systems will receive or have received returns on the investments they make in such systems which could be deemed appropriate for regulatory rate setting purposes. SFAS 51 does not address the question of how to measure, for regulatory rate setting purposes, how much has been invested in a cable television system or how the reasonableness of the return on such amounts should be assessed.

Letter from Deloitte & Touche to Continental Cablevision, Exhibit D hereto.

Amounts that may have been capitalized in accordance with SFAS-51, in short, bear no relation to the substantial benefits that current subscribers receive from the losses and low earnings incurred during a system's early years. Simply stated, if those losses and low earnings had not been incurred, current subscribers would not be able to obtain any cable programming services because there would be no cable system in place to serve them.[17]

Moreover, failing to recognize losses and low earnings as a rate base item will create bad regulatory incentives. If operators cannot expect to recover their losses and low earnings in the form of higher returns in the future, they will have no incentive to make the

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[16] ***See id.***

[17] ***See Cost-of-Service Order*** at ¶ 99.

investments needed to improve and expand cable services in the first place. As the Massachusetts Cable TV Commission recognized, if appropriate ratemaking recognition is not given to these losses and low earnings, investors will have no interest in providing cable service at all. ***Stan-Fran Corp., supra.***

For all of these reasons, the Commission's permanent rules should expressly allow cable operators to include in their rate bases the amount of accumulated return deficiency associated with the operation of a cable system, calculated as described above.

B. There Is No Rational Basis To Deny Recognition of Losses and Low Earnings In A Cable Operator's Rate Base Simply Because The System In Question Was Acquired, Rather Than Built, By Its Current Owner.

Many cable operators did not themselves build their systems and incur the losses and low earnings described above; instead, those losses and low earnings are incurred by the prior owners of the system. That the system has changed hands, however, diminishes neither the necessity of incurring the losses and low earnings nor the direct benefits to current and future subscribers arising from the fact that they were incurred.

In fact, as described below, significant benefits will be lost if relief on the issue of losses and low earnings is limited to original owners of cable systems. If a cable operator knows that potential purchasers of the system will not be able to recover the costs associated with the current owner's low earnings and losses, then the cable operator will have no choice but to hold the system indefinitely (because the owner would not be able

to recover his losses), or forgo the required investments completely. This will ultimately act to discourage investment in developing and expanding cable systems. The public interest is not served by preventing system owners who have developed viable cable businesses from selling the system to others interested in growing the business and adding value for customers.

In addition, the cable industry is currently extremely geographically fragmented, which can prevent operators from achieving efficiencies available when a single support and operations staff can serve a large number of contiguous systems. The public interest is not served by discouraging the sale of systems to existing operators who can realize such efficiencies.

Therefore, a cable operator who has purchased a system from its prior owners should be permitted to include in the rate base an allowance for unrecouped losses and low earnings associated with the operation of the system in prior years.[18] The key question is how to measure the allowance for early year losses and low earnings in the case of a system that has been acquired from its prior owners.[19] As discussed below, there are a number of

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[18] In light of the consumer benefits from allowing acquisition-related intangible assets into a cable operator's rate base described above, doing so would be fully consistent with regulatory precedent relating to such assets. ***See Re Midwest Gas Co.,*** Docket No. G-010/GR-90-678, slip op. (Minn. Pub. Util, Comm'n, July 12, 1991); ***Re Indianapolis Water Co., etc.,*** 75 PUR 4th 643 (Ind. Pub. Serv. Comm'n 1986); ***Re Peoples Gas Sys., Inc.,*** 119 PUR 4th 252 (Fla. Pub. Serv. Comm'n, 1990); and ***Re Application of Northeast Utilities/Public Service Co, of New Hampshire***, 114 PUR 4th 385 (N.H. Pub. Util. Comm'n, 1990).

[19] There is no evidence that Congress intended the Cable Act to exclude the value of intangible assets in valuing cable firms. To the contrary, in the one instance in which Congress has expressed its understanding of the value of cable television systems, it provided that, unless

(continued...)